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SUBJECT: The Chancellor and Hedge Funds

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1. (SBU) Summary: Chancellor Schroeder has pledged to raise "standards for hedge funds" at the G-8 Summit. His position reflects a negative characterization, publicly stated by the Chairman of the SDP and others in the Chancellor's party, of investors fixed on quick financial gain - the proverbial "locusts" - rather than strategic interests of a firm. Senior government leaders have tried to play down the characterization of hedge funds as "locusts" with some arguing that the remarks were made in the context of the ultimately unsuccessful campaign to keep control of the key state of Nordrhein-Westfalen. Others have noted the close relations the Chancellor has had with German business leaders. However, the Chancellor told a party gathering June 13 that he planned to raise hedge funds at the G-8 Summit. Among German financial experts there is disquiet about the Chancellor's position for several reasons. First, hedge funds are already supervised in Germany. Second, investor activism is a corporate governance issue not unique to hedge funds. There may be hedge fund aspects that need to be explored, but the political debate sparked by some Social Democratic Party leaders is not conducive to a factual analysis. This is not the first time the Chancellor has jumped into an economic issue taking views contrary to his Finance Ministry. Basle II, the EU Takeover Bids Directive, and Stability and Growth Pact bear imprints of the ruling Coalition's political agenda that caused them to miss their respective economic marks. End Summary.

Chancellor to Raise Hedge Funds at G-8 Summit

2. (SBU) At a SDP gathering on June 13, Chancellor Schroeder pledged to raise hedge funds at the G-8 Summit. Hedge funds, unregulated in many jurisdictions, principally cater to professional investors by adopting strategies that seek higher yields, which means higher risks. These funds have grown quickly in recent years. Eurohedge estimates total assets under management in the European hedge fund industry is \$250 billion at the beginning of 2005, up from \$170 billion at the beginning of 2004. In 2004, 250 new funds were set up in Europe. Hedge Fund Research estimates that for the first time global investments in hedge funds topped \$1,000 billion as of the end of the first quarter of 2005.

3. (SBU) According to press reports, the Chancellor said, "We want stable markets. We need effective supervision and clearly improved transparency of the hedge-fund market globally. For that reason I will speak out in favor of uniform minimum standards for hedge funds at the G-8 Summit."

4. (SBU) At a June 27th speech to the United States Chamber of Commerce in Washington the Chancellor said that "In Germany, the activities of some hedge funds, which were focused primarily on the short term, lead quite rightly to a few questions." For stable markets, he continued, effective international supervision is needed that requires a "considerable improvement in the transparency of the hedge fund market." Therefore he will propose a "set of international minimum standards for hedge funds" at the G-8 Summit.

German and London Stock Exchanges as Sources of Concern

5. (SBU) One reason for the Chancellor's interest in hedge funds was the political furor stirred by the SPD leadership over the ouster of Werner Siefert, CEO of the

German Stock Exchange Company (Deutsche Boerse (DB)). Some foreign hedge funds insisted that DB use its cash to buy back its own shares, thereby increasing the value of the hedge funds' investments, rather than use the case to purchase the London Stock Exchange (LSE) at a high price. As a senior Finance Ministry official explained, while removals of CEO's is not unusual elsewhere, this was the first such high profile event to occur in Germany. Another reason the issue may have surfaced was an effort by the SPD leaders to get traditional voters energized in an ultimately failed campaign in May to keep control of Germany's largest state.

16. (SBU) Frankfurt financial experts point out that while UK-based hedge funds were the most vocal in opposition to the Company's bid for LSE, Siefert also had failed to gain the backing of German investors and that this is what tipped the scale for his removal. That, however, is a detail lost in the political whirlwind that whipped up at the same time over private equity funds. SDP Chairman Muenteferring, referring to some negative experiences with such funds, likened them to "locusts" striping German companies of profitable assets. In June Secretary Snow pointed out at his Frankfurt press conference, the analogy is misplaced as equity funds make money only by adding value to a firm, ensuring its profitability and attractiveness to sell to other investors.

17. (SBU) Logic, however, was not part of the politics. And the very different case of DB was sucked in with criticism of private equity funds. A senior Finance official, noting the role politics were playing, took comfort in his own assessment that there is no time to enact legislation due to the expectations of snap elections, so nothing substantive would happen in Germany.

Right String , but the Wrong Yo-Yo?

18. (SBU) Finance Ministry and Bafin and finance experts with whom we spoke were not happy with the political discussion. In January 2004 Germany had implemented legislation on hedge funds designed to enhance the attractiveness of Frankfurt as a financial center. The legislation requires such funds to be licensed, audited, and to provide regular reports just like other regulated financial entities. The regulators believe their approach is solid.

19. (SBU) An expert from the German Investment Funds Associated pointed out that the German hedge funds had been slow to take off, with only 17 such funds operating to date, accounting for 1.7 billion euros (out of a total investment funds industry of 1,200 billion euros). Despite industry's appreciation for the legislative initiative, the heavy-handed regulatory regime had scared some business away, with German funds setting up more new funds in Luxembourg than in Germany. In April the Finance Ministry had issued a public discussion paper on the investment fund industry and solicited ideas on how to make hedge fund operations more investor-friendly.

10. (SBU) Among financial experts in Frankfurt, there is a view that hedge funds deserve a closer look, but not for the reasons mentioned by the Chancellor. In their discussion with U.S. Treasury Secretary Snow June 19, German bankers argued for the need for more transparency of hedge funds and their strategies. While sophisticated investors can handle the necessary due diligence when investing in a hedge fund, retail investors may not. In the UK, for example, hedge funds that are unregulated collective investment schemes can only be marketed to a limited class of investors. In Germany, however, a fund composed of various hedge funds can be advertised to the public while riskier single strategy funds cannot, but both can be sold to retail investors. According to an investment fund expert, German banks sell derivatives based on hedge fund indices to retail clients. This activity explains the bankers' interest in greater transparency for all hedge funds, but it is not the same as the Chancellor's.

11. (SBU) Risk management of hedge funds is being taken up by several entities in the EU. In its June "Financial Stability Report", the European Central Bank (ECB) pointed to risks of "crowding of trades" when several hedge funds adopt the same investment strategy in a particular market segment leaving them "vulnerable to adverse market dynamics." The UK's Financial Service Authority issued two discussion papers in June on the hedge fund risks and risk mitigation techniques and on retail investment products, including hedge funds. The European Fund and Asset Management Association is scheduled to publish a survey of European regulation of hedge funds, and hope to provide commentary on the regulatory landscape in a second part of their work. The International Organization of Securities

Commissions Standing Committee on Investment Management is also conducting a stocktaking of regulatory regimes including retail consumers' access to hedge funds.

12. (SBU) While experts think there are issues to discuss, whether new regulation is needed or not is still an open question, and the discussion may have little to do with the corporate governance issues raised by the Chancellor. The FSA discussion paper flatly rejects taking up that topic declaring that ".shareholder activism is not peculiar to the hedge fund sector but rather generic to the entire institutional asset management industry and so can only be addressed in this broader context." When Dr. Gerhard Cromme, chairman of the German Corporate Governance Commission, was asked whether hedge funds looking out for short term gains should be put on a "shorter leash," he replied that hedge funds should not be singled out, explaining that they are just another form of investment funds and that the issue is one of whether their corporate governance was transparent.

Recommendations for Action: "It's Out of Our Hands"

13. (SBU) To prepare the Chancellor for his June 13th speech, a group of experts from the Finance, Economics, and Justice Ministries were tasked with preparing recommendations. At a loss to suggest new regulations on the German hedge fund industry when they were, in reality, leaning against further rules, the group decided on measures "they could live with," in the words of one of the experts. Among the key recommendations were: (a) to lower the threshold at which a single investor has to notify its shareholdings from 5% of total shares to 3% or 2%; (b) to give a extra dividend to shareholders who vote; (c) to broaden the powers of Bafin to investigate when several shareholders are "acting in concert; and (d) to require reporting of short sales based on borrowed shares. The first three are corporate governance measures. The last measure, to gather information when an investor borrows shares and sells them in anticipation of the share price falling, had been considered when adopting regulations in January 2004 but deemed not particularly useful.

14. (SBU) None of these recommendations appeared in the Chancellor's speeches. Instead, the Chancellor talks about transparency and "international minimum standards for hedge funds." When we asked a Finance Ministry expert about this specific sounding proposal, he confessed that he had no idea what it meant or where it came from. After forwarding their recommendations to the Chancellor, the Ministry is no longer in the policy making debate, he said. "Its is out of our hands."

15. (SBU) The office in the Ministry of Economics and Labor charged with G-8 preparations reports that, so far, none of the documents contains any detailed proposal. Rather, their impression is that the Chancellor wants to sensitize other heads of state/government to the issue, ask for G-8 experts to examine it, and see if there is common ground. The Chancellor would probably make extensive comments to the German press on the issue due to the "domestic political context" in which the issue is immersed.

EU Dimension

16. (SBU) German Finance Ministry experts and the UK's FSA paper point out if any measures are to be taken on hedge funds, they should be at a EU level. Fortunately, the European Commission will release a "Green Paper" in July to launch a discussion on whether and, if so, how the Commission should change its mutual fund directive. That paper will raise the question of whether existing EU law should be expanded to cover hedge funds, flagging the issues of investor protection and potential systemic risks. The European Commission, however, has no preconceived notions on whether to have regulations on hedge funds, according to a Commission expert.

17. (SBU) The author of the Commission paper commented that, in his view, the Germans are interested in corporate governance issues, a topic that will not be addressed in the "Green Paper." He admitted that the pressure by the Germans to do something was increasing, but also thought that the political debate was not conducive to considered reflection on the issue. According to a fund industry expert, the Commission is likely to devote its initial attention to improving implementation of existing law, leaving more ambitious projects, like covering hedge funds, for later.

Chancellor as CFO

18. (SBU) This is not the first time the Chancellor has

jumped into financial issues, taking a different tack from his finance experts. On Basle II he sought a weakening of risk weights for lending to SMEs after Bafin had agreed to the draft provisions. On the EU Takeover Bids Directive he orchestrated blockage of its passage in the European Parliament after the German Presidency had secured its agreement in the Council. On the Stability and Growth Pact he publicly rebuked the European Commission for trying to issue Germany a warning that it risked running a deficit over 3% of GDP, a warning the Finance Minister had been willing to accept for leverage to instill budget discipline. In each of these cases the Chancellor pursued his political objective, causing each of these projects to miss some of their respective economic objectives.

¶19. (U) This report coordinated with US Embassies Berlin and Paris and USEU.

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